SPENCER W. & LESLIE E. DANZEY 516 S. MAIN STREET HEADLAND, AL 36345,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NOS. INC. 12-1003 INC. 11-527
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

These consolidated appeals involve final assessments of 2007 and 2010 income tax entered against Spencer W. and Leslie E. Danzey, (jointly "Taxpayers"), and 2008 and 2009 income tax final assessments entered against Spencer W. Danzey, (individually "Taxpayer"). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on March 20, 2014. Ben Armstrong represented the Taxpayers. Assistant Counsel Billy Young represented the Department.

The primary issue in this case is whether a cattle farm operated by the Taxpayer during the subject years constituted a trade or business, in which case the expenses relating to the activity can be deducted as ordinary and necessary business expenses. See generally, Code of Ala. 1975, §40-18-15(a)(1). That issue turns on whether the Taxpayer conducted the activity primarily for profit.

The Taxpayer grew up on a farm in Henry County in Southeastern Alabama. He graduated from law school and was admitted to the Alabama Bar in 2003. He initially practiced with a law firm in Dothan, but moved his practice to Abbeville in 2006.

The Taxpayer and another person purchased approximately 15 heifers in 2004, and shortly thereafter purchased 15 to 20 more. They also purchased a bull and began breeding the heifers. The Taxpayer kept the cattle on a 230 acre farm owned by his father, who had inherited the farm from his father. The Taxpayer bought out his partner in 2008, and since that time has tended to the cattle with his father's help.

The farm is midway between the Taxpayer's house in Headland and his office in Abbeville. The Taxpayer testified that on many days during the week, he stops by the farm on his way home after work to tend to the cattle. He explained that his father is retired and helps him with the cattle, and that together they are able to feed, water, and otherwise tend to the animals. He also works on the farm most weekends cutting grass, mending fences, fertilizing, etc.

The Taxpayer maintained approximately 40 or 50 cattle on his farm during the years in issue. He indicated that 50 head is about all that he and his father can handle, although he has owned up to 75.

The Taxpayer's father also owned cattle, and the Taxpayer grew up working with and tending to his father's cattle. He testified that he enjoys working with and tending to the cattle, and generally doesn't mind the physical labor required to operate a cattle farm.

The Taxpayer reported no cattle-related income on his 2004, 2005, and 2006 Alabama returns, and Schedule F cattle-related losses of $5,722, $16,215, and $20,132, respectively, in those years.

During the years in issue, 2007 through 2010, the Taxpayer reported Schedule F farm income of $34,111, $0, $25,500, and $10,030, respectively. During those same years, he reported net farm-related losses of $42,855, $94,117, $105,962, and $80,741, respectively. A large part of the losses in most years was attributable to depreciation.

The Department audited the Taxpayers for the subject years and determined that the Taxpayer's farming activity was not a for profit business. It consequently allowed the farm-related expenses to offset the farm income in each year, and disallowed the balance. This appeal followed.

The Administrative Law Division has decided numerous cases involving the issue of whether an activity was entered into for profit. In *Blankenship v. State of Alabama*, Docket Inc. 06-1215 (Admin. Law Div. O.P.O. 10/16/2007), the Division explained the criteria to be applied in deciding the issue.

> The general test for whether a taxpayer is engaged in a "trade or business," and thus entitled to deduct all ordinary and necessary business expenses, is "whether the taxpayer's primary purpose and intention in engaging in the activity is to make a profit." *State of Alabama v. Dawson*, 504 So.2d 312, 313 (Ala. Civ. App. 1987), quoting *Zell v. Commissioner of Revenue*, 763 F.2d 1139, 1142 (10th Cir. 1985). To be deductible, the activity must be engaged in "with a good faith expectation of making a profit." *Zell*, 763 F.2d at 1142. As stated by the U.S. Supreme Court – "We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify." *Commissioner v. Groetzinger*, 107 S. Ct. 980, 987 (1987). But a taxpayer's expectation of a profit need not be reasonable. Rather, the taxpayer must only have a good faith expectation of realizing an eventual profit. *Allen v. Commissioner*, 72 T.C. 28, 33 (1979). Whether the taxpayer had an intent to make a profit must be determined on a case-by-case basis from all the circumstances. *Patterson v. U.S.*, 459 F.2d 487 (1972).
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> Treas. Reg. §1.183-2 specifies nine factors that should be considered in determining if an activity was entered into for profit.
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> Factor (1). The manner in which the taxpayer conducted the activity.
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> Factor (2). The expertise of the taxpayer in carrying on the activity.
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> Factor (3). The time and effort exerted by the taxpayer in conducting the activity.
> Factor (4). The expectation that the assets used in the activity will appreciate.

> Factor (5). The taxpayer's success in similar or related activities.
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> Factors (6) and (7). The taxpayer's history of profits and losses, and the amounts of any occasional profits.
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> Factor (8). The taxpayer's financial status.
>
> Factor (9). The activity was for the taxpayer's personal pleasure and recreation.

Blankenship at 3 – 4.

"Hobby loss" cases are almost always difficult to decide because in most cases some of the above nine factors will indicate that the activity was for profit, while other factors will suggest that it was a hobby. Even if the activity was a hobby, the taxpayer would still want to profit from the activity, if possible. Conversely, taking pride in and enjoying a business activity does not make the activity a hobby. "A person can obviously take pride in a profit-motivated venture." *Blankenship*, supra at 6.

Deciding this case is even more difficult because the Department examiner that audited the Taxpayers did not testify at the hearing. Such testimony is generally helpful because it allows the parties, and the trier of fact, to ask questions and obtain evidence necessary and useful in deciding if the activity was a profit motivated business versus a hobby. For example, while there is testimony that the Taxpayer used a single checking account for both personal and farm expenses, there is no evidence that the Taxpayer did or did not maintain organized, complete records of his farm-related expenses. That fact, and others not in evidence in this case, are important in determining if the activity was a business or a hobby.

As usual, some of the nine factors favor the Taxpayer in this case, while others favor the Department. A factor in the Taxpayer's favor is that he grew up around cattle, and consequently knows how to tend to and raise cattle. The same applies to the Taxpayer's father, who regularly helps the Taxpayer on the farm.

The primary factor cited by the Department is the amount of the farm losses claimed in the subject years - $42,855, $94,117, $105,967, and $80,741 in 2007 through 2010, respectively. Even after depreciation is removed, the Taxpayer had out-of-pocket cash losses of approximately $42,900, $51,000, $38,500, and $55,600, respectively, in the subject years. The Taxpayer's law practice gross income in those years was approximately $72,900, $104,000, $136,000, and $125,000, respectively. It is assumed that the Taxpayer paid his family's medical insurance premiums out of his wages, paid his FICA taxes, and also had some percentage of both State and federal income tax withheld from his wages (or paid in quarterly estimates), which would substantially reduce the take home pay from his law practice. Consequently, given the large Schedule F losses, the Taxpayer lost nearly half of his disposable income on his cattle farm during the years in issue.

If anything, however, the above facts indicate that the Taxpayer intended and expected to eventually make a profit on his cattle. The Taxpayer is relatively young and has a wife and a young child at home. It is unreasonable to believe that someone in that situation, and there is no evidence that the Taxpayer has family wealth or other income besides wages, would spend (and lose) over one-half of their relatively limited disposable income on a nonprofit motivated hobby such as raising cattle. That is, no one would spend one-half of their disposable income on an activity unless they expected in good faith to eventually make a profit from the activity. It is thus reasonable to conclude that the Taxpayer intended and thought, and still thinks, that he can eventually turn a profit from his cattle farm. And while the Taxpayer's judgment and decision to continue operating the cattle farm year after year at a loss may be questioned, it is not required that the expectation of profit must be reasonable. *Allen v. Commissioner*, 72 T.C. 28, 33 (1979).

Considering the circumstances as a whole, I find that the Taxpayer's cattle farming activity was entered into for profit. The Taxpayer's ordinary and necessary cattle-related expenses can thus be deducted as business expenses in the years incurred, but only if they were properly documented by the Taxpayer.

As discussed, there is no testimony that the Taxpayer did or did not keep adequate records verifying the claimed Schedule F expenses, depreciation, etc. An "Explanation of Adjustments" submitted by the Department at the March 20 hearing does indicate that "[t]he taxpayer failed to support the expenses listed on Schedule E and Schedule F for tax year 2008." The document further states that the Taxpayer "did not file a 2009 Alabama income tax return. A blanket return has been prepared for the taxpayer." The Taxpayer subsequently filed a 2009 return after appealing to the Administrative Law Division. The examiner made changes using that return, but what the changes were are not in evidence.

The burden is on a taxpayer to provide complete and adequate records verifying all claimed deductions and expenses. *McDonald v. C.I.R.*, 114 F.3d 1194 (1997); *Norgaard v. C.I.R.*, 939 F.2d 874 (1991). It is unclear what records the Taxpayer provided to the Department examiner concerning the Schedule F expenses. The Department should identify and submit a list to the Division by October 17, 2014 of the Schedule F expenses that were verified by the Taxpayer, and thus should be allowed, and those that were not. The list will be submitted to the Taxpayer, who will thereafter be allowed a reasonable time to submit any additional records in support of the farm-related deductions.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered September 24, 2014.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Warren W. Young, Esq.
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